

Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

Team Manager
(Large & Mid-Size Business)

from:

Attorney
(Large & Mid-Size Business)

subject: Small Ethanol Producer Credit – Qualification as an eligible small ethanol producer

This memorandum responds to your request for assistance dated April 17, 2009. This advice may not be used or cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our view.

LEGEND

Taxpayer	=
LLC	=
Company A	=
Company B	=
Company C	=
City	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=

Date 6	=
Date 7	=
Date 8	=
Date 9	=
A	=
B	=
C	=
D	=
E	=
F	=
G	=
H	=
I	=
J	=
K	=
L	=

ISSUE

Did Taxpayer qualify for the small ethanol producer credit under I.R.C. § 40(a)(3) for its taxable year commencing Date 1 and ending Date 9 for the ethanol produced by LLC during the period Date 1 through Date 2?

CONCLUSION

Taxpayer did not qualify for the small ethanol producer credit because it was not an “eligible small ethanol producer” within the meaning of I.R.C. § 40(g) for the taxable year ending Date 9 as Taxpayer was deemed to have had productive capacity in excess of 60 million gallons at some time during the taxable year. Taxpayer and LLC were treated as one person under the aggregation rule under I.R.C. § 40(g)(2) because of Taxpayer’s ownership of more than 50% of LLC capital interest and profit interest during the period Date 3 through Date 7, and LLC had productive capacity in excess of 60 million gallons as of Date 6 which is before Date 7.

FACTS

Taxpayer is an exempt farmers’ cooperative under I.R.C. § 521, with A members as of Date 9. As used in this document, Dates 1 through 9 are numbered sequentially in chronological order.

LLC is a limited liability company that was organized by Taxpayer pursuant to a contribution of assets in exchange for B membership units in LLC, which represented 100% of the outstanding LLC membership units. During the period Date 1 through Date 2, Taxpayer treated LLC as a disregarded entity pursuant to the default classification rule in Treas. Reg. § 301.7701-3(b)(1)(ii). During this period LLC was treated as a division of Taxpayer for income tax purposes as provided in Treas. Reg. § 301.7701-

2(a). LLC owned and operated an ethanol production facility (Ethanol Facility) located in City.

LLC issued an aggregate of C membership units to Company A in several transactions between Date 3 and Date 5, and it issued an additional D membership units to Taxpayer as of Date 5. LLC issued E membership units to Company B effective as of Date 4. Company A and Company B were unrelated to Taxpayer. Pursuant to Treas. Reg. § 301.7701-3(f)(2) and the default classification rule in Treas. Reg. § 301.7701-3(b)(1)(i), LLC was reclassified as a partnership for income tax purposes upon the admission of an additional member effective as of Date 3.

Effective as of Date 8, LLC's operating agreement was amended and Company C made a capital contribution of \$F in cash to LLC in exchange for G Class C membership units, which represented greater than 50% of the outstanding LLC membership interests. In connection with Company C's capital contribution and as contemplated in the purchase agreement between LLC and Company C, LLC distributed approximately \$H in cash to Taxpayer, Company A and Company B. The capital contribution by Company C and related distributions to Taxpayer, Company A and Company B were treated under I.R.C. § 707(a)(2)(B) as a disguised sale to Company C by Taxpayer, Company A and Company B of a portion of their LLC membership units, causing a termination of LLC under I.R.C. § 708(b)(1)(B) and a closing of its tax year under I.R.C. § 706(c). LLC filed returns for the short taxable years Date 3 through Date 7, and Date 8 through Date 9.

During the period Date 3 through Date 7, Taxpayer owned more than 50% of the outstanding LLC membership units. In the LLC return for the short taxable year Date 3 through Date 7, Taxpayer was reported as having more than 50% of the LLC capital and more than 50% of the LLC profits and losses. During the period Date 8 through Date 9, Taxpayer owned less than 50% of the outstanding LLC membership units. In the LLC return for the short taxable year Date 8 through Date 9, Taxpayer was reported as having less than 50% of the LLC capital and less than 50% of the LLC profits and losses.

As of Date 1, the Ethanol Facility had productive capacity for ethanol of I gallons per year, which does not exceed 60,000,000 million gallons. The Ethanol Facility was expanded to increase its productive capacity to J gallons per year, which exceeds 60,000,000 gallons, by Date 6. The Ethanol Facility produced K gallons of ethanol during the period between Date 1 and Date 2. Taxpayer reported K gallons, which does not exceed 15,000,000 gallons, of qualified ethanol fuel production on Form 6478 attached to Taxpayer's amended Form 990-C for the taxable year ending Date 9. Taxpayer claimed a small ethanol producer credit of \$L on Form 6478.

LAW

Section 40 allows an alcohol fuels credit, which is part of the general business credit under § 38. Under § 40(a)(3), the alcohol fuels credit includes a small ethanol producer

credit for eligible small ethanol producers; under § 40(b)(4)(A), the amount of this credit for any taxable year is 10 cents for each gallon of qualified ethanol fuel production of an eligible small ethanol producer. Section 40(b)(4)(C) limits the qualified ethanol fuel production of any producer for any taxable year to not more than 15 million gallons. Section 40(g)(1) defines “eligible small ethanol producer” as a person who, at all times during the taxable year, has a productive capacity for alcohol not in excess of 60 million gallons.

An aggregation rule in § 40(g)(2) provides that for purposes of the 15 million gallon production limitation under § 40(b)(4)(C) and the 60 million gallon productive capacity limitation under § 40(g)(1), “all members of the same controlled group of corporations (within the meaning of section 267(f)) and all persons under common control (within the meaning of section 52(b) but determined by treating an interest of more than 50 percent as a controlling interest) shall be treated as 1 person.”

Section 52(b) provides that all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer. Section 1.52-1(b) defines “trades or businesses that are under common control” as including any group of trades or businesses that is a parent-subsidary group under common control. Section 1.52-1(c)(1) generally defines “parent-subsidary group under common control” as one or more chains of organizations conducting trades or businesses that are connected through ownership of a controlling interest with a common parent organization if (i) a controlling interest in each of the organizations, except the common parent organization, is owned by one or more of the other organizations; and (ii) the common parent organization owns a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by the other organizations. Section 1.52-1(c)(2)(iii) defines “controlling interest” in the case of a partnership as ownership of more than 50 percent of the profit interest or capital interest of the partnership.

A pass-through entity rule in § 40(g)(3) provides that in the case of a partnership, trust, S corporation, or other pass-thru entity, the 15 million gallon production limitation under § 40(b)(4)(C) and the 60 million gallon limitation in § 40(g)(1) shall be applied at the entity level and at the partner or similar level.

Section 40(g)(5) authorizes the Secretary to prescribe regulations to prevent the small ethanol producer credit from benefiting a person that directly or indirectly has a productive capacity for alcohol in excess of 60 million gallons during the taxable year and to prevent any person from directly or indirectly benefiting with respect to more than 15 million gallons during the taxable year. Proposed Treasury Regulations § 1.40-2(c) disallows the small ethanol producer credit for ethanol produced at the facilities of a

contract manufacturer if the contract manufacturer has a direct or indirect productive capacity of more than 60 million gallons of alcohol during the taxable year¹:

The person at whose facilities ethanol is produced is treated for purposes of section 40(g)(5) as an indirect beneficiary of any credit allowed with respect to the ethanol. Accordingly, the small ethanol producer credit is not allowed with respect to ethanol that is produced at the facilities of a contract manufacturer or other person if such contract manufacturer or other person has a direct or indirect productive capacity of more than 60 million gallons of alcohol during the taxable year. . . .

Proposed regulations § 1.40-2(d) Example 2 provides an example applying the contract manufacturer rule:

Y arranges with contract manufacturer Z to produce 10 million gallons of ethanol. Y is not related to Z. Y provides the raw materials and retains title to them and to the finished ethanol. Z has the capacity to produce 100 million gallons of alcohol per year. The small producer credit is not allowed with respect to the 10 million gallons of ethanol because it is produced at the facilities of a contract manufacturer that has a productive capacity of more than 60 million gallons of alcohol during the taxable year.

ANALYSIS

As a condition for qualifying for the small ethanol producer credit for its taxable year ending Date 9, Taxpayer must have been an “eligible small ethanol producer”, which requires that Taxpayer’s productive capacity for alcohol was not in excess of 60 million gallons at all times during such taxable year. As discussed below, although Taxpayer was considered to have productive capacity for alcohol not in excess of 60 million gallons per year from Date 1 until completion of the Ethanol Facility expansion in Date 6, Taxpayer was considered to have productive capacity in excess of 60 million gallons from Date 6 through Date 7. As Taxpayer was considered to have had productive capacity in excess of 60 million gallons at some time during the taxable year, Taxpayer was not an eligible small ethanol producer at all times during the taxable year and therefore did not qualify for the small ethanol producer credit for the ethanol produced from Date 1 through Date 2.

The Ethanol Facility had productive capacity of 1 gallons during the period Date 1 through Date 2, at which time LLC was classified as a disregarded entity and was considered to be a division of Taxpayer. During this period, Taxpayer was considered to have productive capacity for alcohol not in excess of 60 million gallons per year.

¹ Note that proposed regulations cannot be cited as precedent. We are restating it here to respond to the Taxpayer’s argument described below that incorporates the proposed regulation.

During the period that LLC was classified as a partnership commencing Date 3, Taxpayer and LLC would be treated as one person for purposes of the 60 million gallon productive capacity limitation under the aggregation rule in § 40(g)(2) if they were considered to be under “common control”, and they would be considered under common control if Taxpayer was the owner of more than 50 percent of the profit interest or capital interest of LLC, as provided in §§ 1.52-1(b), (c)(1), and (c)(2)(iii). LLC was under the “common control” of Taxpayer within the meaning of §§ 40(g)(2) and 52(b) during the period Date 3 through Date 7 because during such period Taxpayer owned more than 50% of the LLC profit interest and more than 50% of the LLC capital. Therefore, Taxpayer and LLC were treated as one person during such period under the aggregation rule in § 40(g)(2) for purposes of applying the 60 million gallon per year productive capacity limitation.

Under the aggregation rule, Taxpayer and LLC had combined productive capacity of 1 gallons from Date 3 until completion of the Ethanol Facility expansion in Date 6, and combined productive capacity of 1 gallons from Date 6 through Date 7. As Taxpayer was considered to have productive capacity in excess of 60 million gallons at some time during its taxable year ending Date 9, Taxpayer was not an eligible small ethanol producer at any time during such taxable year. Therefore, Taxpayer did not qualify for the small ethanol producer credit for the ethanol production during the period Date 1 through Date 2.

RESPONSE TO TAXPAYER'S POSITION

Taxpayer's position is that Taxpayer qualified as an eligible small ethanol producer during the period Date 1 through Date 2, because during such period it was the deemed owner of the Ethanol Facility and its productive capacity did not exceed 60 million gallons. Taxpayer's primary argument is that during the period commencing Date 3, the productive capacities of Taxpayer and LLC should not be combined under the aggregation rule in § 40(g)(2) for purposes of the productive capacity limitation. Taxpayer's alternate argument is that, if it is necessary to consider LLC's productive capacity, Taxpayer qualified as an eligible small ethanol producer by applying the productive capacity limitation at the level of Taxpayer's patrons under the pass-through entity rule in § 40(g)(3).

Taxpayer's primary argument is that the productive capacities of Taxpayer and LLC should not be combined under the aggregation rule in § 40(g)(2) for purposes of applying the productive capacity limitation. Taxpayer concedes that LLC did not qualify as an eligible small ethanol producer during the period Date 3 through Date 7 and that Taxpayer and LLC were under common control within the meaning of § 40(g)(2) during the period Date 3 through Date 7. However, Taxpayer argues that the aggregation rule in § 40(g)(2) does not require combining the productive capacity of a person that is not an eligible small ethanol producer (such as LLC) with the productive capacity of a person that is an eligible small ethanol producer (such as Taxpayer).

Contrary to Taxpayer's position, the application of 60 million gallon productive capacity limitation under § 40(g)(1) and the aggregation rule in § 40(g)(2) is not limited only to entities that are eligible small ethanol producers when considered in isolation from other related entities, nor does the application of the rules exclude consideration of any entities that are not eligible small ethanol producers when considered in isolation. The aggregation rule under § 40(g)(2) is applied to determine whether "all persons under common control" satisfy the productive capacity limitation when considered in the aggregate. The term "persons" refers to all entities under common control regardless of whether an entity satisfies the productive capacity limitation when considered in isolation. For example, if two entities under common control each satisfied the productive capacity limitation individually during the taxable year but collectively exceeded the limitation at some point during the taxable year, then neither entity would be an "eligible small ethanol producer" at any time during the taxable year under the aggregation rule. Similarly, if two entities under common control included one entity that satisfied the productive capacity limitation while the other entity exceeded the limitation at some point during the taxable year, then neither entity would be an "eligible small ethanol producer" at any time during the taxable year under the aggregation rule.

Taxpayer argues that its position is supported by Example 2 of Proposed Treasury Regulations § 1.40-2(d), because the aggregation rule under § 40(g)(2) was not applied in the example to combine the contract manufacturer's productive capacity with the producer's productive capacity. Taxpayer argues that in this case LLC could be considered a contract manufacturer for Taxpayer and therefore LLC's productive capacity should not be combined with Taxpayer's. Contrary to Taxpayer's interpretation of the proposed regulation, the § 40(g)(2) aggregation rule was not applied in the example because the contract manufacturer and other party were unrelated. Since the parties in the example were unrelated, the aggregation rule in § 40(g)(2) was inapplicable. Regardless of whether LLC may have been a contract manufacturer for Taxpayer, the rule in § 40(g)(5) and the contract manufacturer rule in the proposed regulations does not apply in this case because Taxpayer and LLC were under common control and therefore were treated as one person under the aggregation rule in § 40(g)(2).

Taxpayer also argues that LLC's productive capacity would have been relevant for purposes of applying the productive capacity limitation to Taxpayer only if LLC had been an eligible small ethanol producer and had made an allocation of the small ethanol producer credit to Taxpayer. It is true that if LLC was an eligible small ethanol producer and had made an allocation of the small ethanol producer credit to Taxpayer, it would have been necessary for Taxpayer to apply the productive capacity limitation at the LLC member level under the pass-through entity rule in § 40(g)(3) in order to determine whether Taxpayer qualified for the credit. However, contrary to Taxpayer's position, the application of the productive capacity limitation under § 40(g)(1) and the aggregation rule in § 40(g)(2) is not limited to persons that satisfy the productive capacity limitation when considered in isolation of other related entities.

Taxpayer's alternative argument is that, if it is necessary to consider LLC's productive capacity for purposes of applying the productive capacity limitation to Taxpayer, the pass-through entity rule in § 40(g)(3) requires applying the productive capacity limitation at the partner or similar level, in which case LLC's productive capacity would be allocated through Taxpayer to Taxpayer's patrons and the productive capacity limitation would be tested at the patron level. Given that Taxpayer had a large number of patrons between Date 1 and Date 9, Taxpayer argues that the productive capacity limitation would not have been exceeded based on each patron's pro rata share of Taxpayer's pro rata share of LLC's productive capacity. Taxpayer argues that because the productive capacity limitation was satisfied at the patron level, Taxpayer was an eligible small ethanol producer.

Under Taxpayer's interpretation of § 40(g)(3), the productive capacity limitation applies at the partner or similar level to determine whether a pass-through entity satisfies the productive capacity limitation. Contrary to Taxpayer's position, the productive capacity limitation is applied at the partner or similar level to determine whether an owner of a pass-through entity qualifies for the small ethanol producer credit if the owner receives an allocation of the credit from one or more pass-through entities.

The application of the partner or similar level rule in § 40(g)(3) does not apply in this case because Taxpayer was not an eligible small ethanol producer under the productive capacity limitation under § 40(g)(1) and the aggregation rule under § 40(g)(2) during the entire taxable year ending Date 9. Once Taxpayer exceeds the production capacity limitations, no further inquiry is required regarding the production capacity of Taxpayer's patrons since the credit is not available at this point.

SUMMARY

Taxpayer and LLC were considered to be one person during the period Date 3 through Date 7 pursuant to the aggregation rule in § 40(g)(2) because of Taxpayer's ownership of more than 50% of the LLC capital interest and profit interest during such period. During the period commencing on Date 6, Taxpayer and LLC were considered to have combined productive capacity of 1 gallons, which exceeded the 60 million gallon limitation in § 40(g)(1). Because the combined productive capacities of Taxpayer and LLC exceeded the 60 million gallon productive capacity limitation at some time during the taxable year ending Date 9, Taxpayer was not an eligible small ethanol producer at any time during the taxable year. Therefore, Taxpayer did not qualify for the small ethanol producer credit for LLC's ethanol production during the period Date 1 through Date 2.

We have coordinated this advice with Associate Chief Counsel (Passthroughs and Special Industries) and the Industry Counsel, Agriculture. Please call _____ if you have any further questions.

Associate Area Counsel
(Large & Mid-Size Business)

By: _____

Attorney
(Large & Mid-Size Business)